Module IX: Understanding the Importance of Asset Allocation

Summary: ***Research demonstrates that proper asset allocation determines 90% of your investment return.*** *The remaining 10% of your return is actually determined by* ***which*** *investments, within an asset category, you select. The proper use of asset allocation combined with applying the basic fundamentals of investing discussed in the other modules will maximize the amount of return on your investments, for a given amount of risk, over time. Just as you would not recommend a personal diet consisting of the same food every day, you cannot afford to let your financial "diet" fall into the same trap by investing in only one investment class. Having investments that perform differently from each other under various market conditions will help you decrease your risk and balance your investment dollars wisely. This module explains what the major classes of assets are, what asset allocation is, how it works, and how to select the right asset allocation model for you.*

What are the Asset Classes?

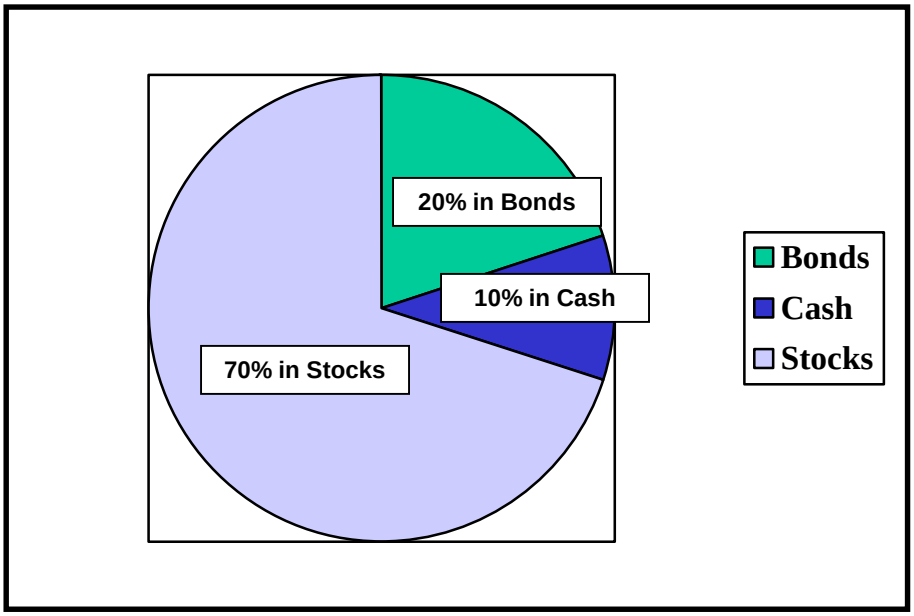
Most investors categorize investments into three major classes of assets: stocks, bonds, and cash. Stocks (see Module VIII) represent ownership in companies (our recommendation for beginning investors is to invest in diversified mutual funds (see Module VI) when making "stock" investments). Bonds (see Module VII) represent debt instruments where investors loan money to eventually be paid back with interest, and cash can be a savings, checking, or money market account. By far, stocks and bonds represent the greatest percentage of holdings in most investment portfolios, with stocks being the riskier asset of the two. Remember, the greater the amount of expected return for an asset class, the greater amount of risk associated with it. Stocks have outperformed bonds over long periods of time, but this potential for greater return comes with a greater amount of risk.

Each asset class can be further subdivided into separate categories. For example, stocks can be further categorized by the size of the companies, the industries the companies operate in, the companies' objectives (e.g. growth versus income), and the locations of the companies (e.g. US versus Europe). Bonds can also be broken down by type (government versus individual company) and longevity (i.e. time until the bond matures). The focus of this module is asset allocation at the macro level: combining the

three types of asset classes in the proper mix designed for achieving a certain amount of growth for a given amount of risk tolerance.

What is Asset Allocation?

The best way to begin the discussion is to provide a simple example. Assume you have $100 to invest and you invest it in the following proportions: you purchase $70 of stocks and $20 of bonds, and put the remaining $10 in a savings account (representing a cash holding). In simple terms, this distribution of your money is called asset allocation. Many times, asset allocation is described in percentage terms. In this case, 70 percent is allocated to stocks, 20 percent to bonds, and 10 percent to cash. The following pie chart shows this simple allocation:



Asset allocation is based on the proven theory that the mixture or combination of types of investment assets (e.g. bonds, stocks, and cash instruments) you own is much more important in terms of investment return than holding a particular security (e.g. actual company stock, bond, etc.) within an asset class itself. What this means is that your investment return is determined more by how you allocated your investment dollars among the different asset categories, than by what choices you made within an asset class itself. For example, the weighting you place towards stocks (percent of investment dollars invested in the stock asset class) in your portfolio will account for much more of the portfolio investment return than

the actual stocks that make up the investment in the stock asset class, assuming you own a diversified stock portfolio. So the key factor is not whether you chose to invest in Microsoft, for example, but more importantly, how much of your total portfolio dollars are allocated to the stock investment class.

One reason asset allocation is so important is that it significantly impacts the risk of your portfolio. When you combine different asset classes within your portfolio, you can better protect yourself from market factors you cannot control. Some of these factors are inflation, rising or falling interest rates, market sectors or industries coming into or falling out of favor, a recession, etc.

Some investors confuse asset allocation with simple diversification. For example, with diversification, individual risky stocks can be combined in such a way that the combination of individual stocks is less risky than any one of the stocks by itself. So, it is possible to have a diversified portfolio consisting of only one asset class. Asset allocation takes it a step further by combining the different asset classes in such a way to achieve a greater amount of portfolio diversification. Proper asset allocation enhances the portfolio's diversification and allows you to more finely tune your portfolio to balance expected return against risk.

A general rule of thumb is the longer you intend to hold an investment, the more money you should allocate toward stocks. As discussed in Module VIII: Investing in Stocks, the stock market offers the greatest potential return, by far, over long periods of time.

Why do investments behave the way they do?

Why is it that you can combine different assets and lower the risk of an investment portfolio? The answer comes down to correlation – defined as how the investments react to changes in the market place relative to each other. If investments are positively correlated to each other, they move up and down together; conversely, if investments are negatively correlated, they move the opposite of one another. The more positively correlated the investments are, the less risk you can diversify away. Usually, different asset classes exhibit a lesser degree of positive correlation to each other than assets within one class. For example, a combination of stocks and

bonds in a portfolio will generally be less positively correlated and in turn less risky than a mixture of just stocks alone.

One mistake new investors often make is trying to chase the returns of top performing mutual funds from the prior year. Often these investors will build a portfolio loaded only with top-performing mutual funds from the year prior. These investors think they are building a diversified portfolio because the mutual funds own many different stocks, but they fail to take into account how positively correlated the mutual funds are to each other. Usually, mutual funds that perform very well for the same time periods have invested in the same growing industries. These "hot" funds will usually have many characteristics in common and will exhibit a strong positive correlation causing them to react almost exactly the same to changes in market conditions. Proper diversification and asset allocation helps to combat the risk of buying very positively correlated investments. This is more difficult when investing in only one type of asset class, like stocks, because most stocks are positively correlated with each other. Even stocks operating within different industries are generally more positively correlated to each other than stocks are to bonds, for example.

How are Asset Allocation Models Built?

As with any decision, planning your own asset allocation can range from simple to complex. One simple way to determine the correct mix of assets for your portfolio is to use a tool designed to provide insight on your risk tolerance as it relates to your investment goals. Many websites offer tools, also called "optimizers," to help you determine the proper mix of asset classes to combine to form your portfolio. These tools require you to answer various questions in order for them to calculate your proper mix of assets. Some of the many factors taken into account include, but are not limited to, your investment time horizon (how long you want your money invested based on the timing of your retirement and other investment goals), your risk tolerance (the level of risk you are willing to expose your investments to), your financial situation (how much money you have to invest, future income growth/needs, tax situation, etc.), and your own goals (what you want your investments to achieve).

These tools are designed to create an asset mix that is proper for you given your individual characteristics. The problem with these tools is they tend to offer certainty with a task that is very subjective. These allocation

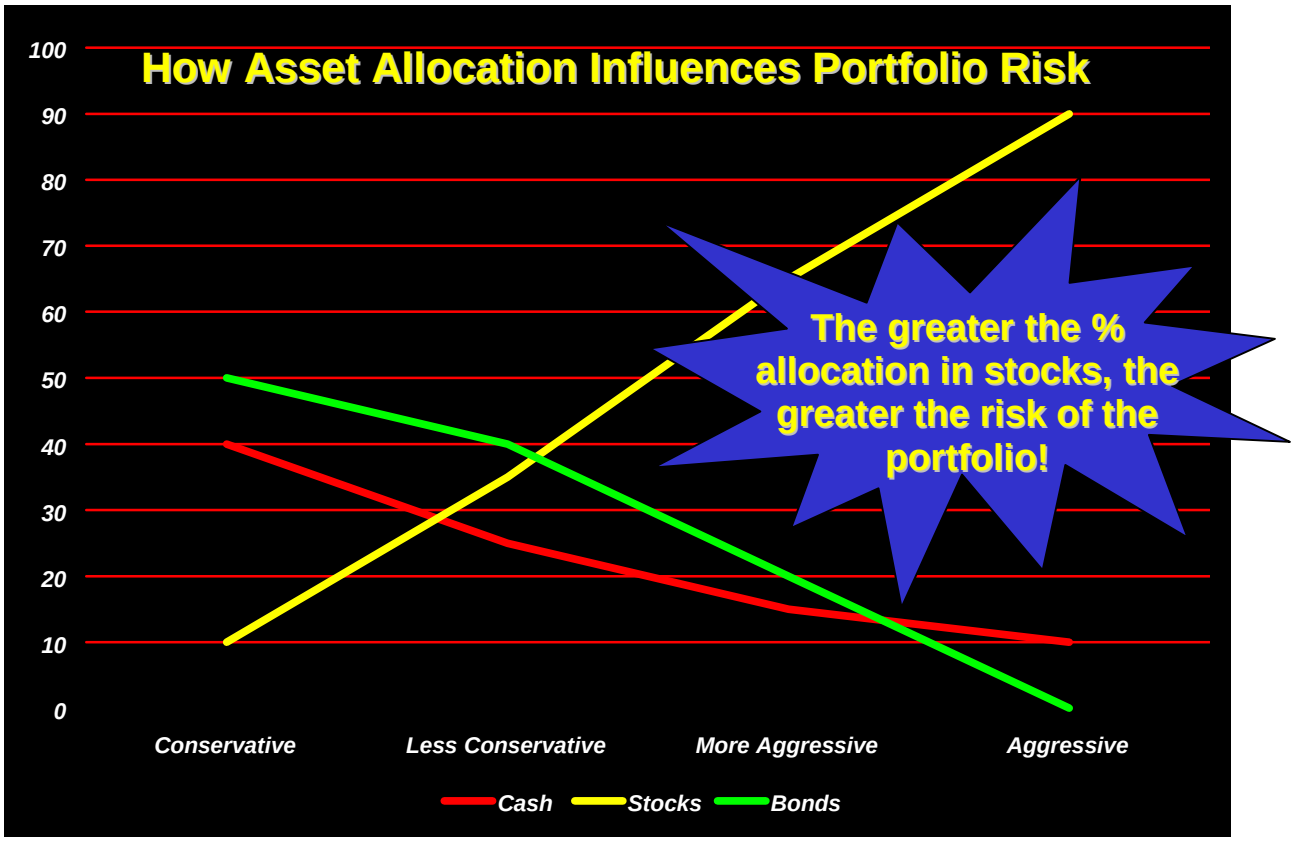
optimizers can also vary widely in results based on small changes to answers to their questions. They do offer a start, but the recommendation is to either use a financial advisor or do an extensive amount of reading to determine what is right for you.

Usually, a financial advisor will build an asset allocation model by first considering the historical performance data of different types of asset classes over time. The advisor will then make forecasted projections using this data. Often, advisors will use computer programs designed to help facilitate selecting the proper asset allocation to meet your individual needs. In combination with the computer results and the advisor's experience, he/she will design an asset allocation that is best suited for your situation. A more detailed discussion of the process follows.

The advisor will carefully balance expected return, risk and correlation when designing the proper asset allocation model for you. First, he/she considers the amount of ***expected return*** required to meet your investment objectives. The expected return is an estimate of what the portfolio must earn, including income and capital gains, to achieve the objectives. Each asset class has a different expected return based on both historical performance and economic projections. The next consideration is ***risk***. Risk is measured by analyzing the asset class's past volatility. If an investment's returns are volatile, meaning they swing greatly in performance from year to year, it is considered to be a high-risk investment. Finally, the ***correlation*** between the investment alternatives is considered because, when <u>combined</u> into a portfolio, some of the risk associated with the <u>separate</u> asset classes can be lessened if their price fluctuations do not move exactly together. As discussed briefly above, this is a mathematical computation the computer calculates by quantitatively analyzing the extent to which asset classes tend to rise and fall together. If there is a high correlation between investment alternatives, then the portfolio is exposed to a higher degree of risk than if the investments are more negatively correlated. The optimum asset mix involves achieving the lowest degree of correlation between the asset classes for a given expected return on the portfolio.

Below is a very simplistic graph designed to depict generic portfolio risk associated with combining the three asset classes (stocks, bonds and cash) in various percentages. The vertical axis measures the percentage of a particular asset class included in the portfolio, and the horizontal axis

measures the amount of risk associated with combining the assets in the percentage terms depicted—portfolio combinations depicted further to the right on the chart exhibit more relative risk than those to the left. For example, let us examine the portfolio at the furthest point on the right of the graph—this represents the most aggressive portfolio combination. This combination represents 90% invested in stocks, 10% invested in cash, and nothing invested in bonds. In this case, this is the "riskiest" portfolio depicted on the graph (remember risk represents the degree of fluctuation in price of the asset). This makes sense, because stocks are the riskiest asset class of the three and this portfolio includes stocks in the greatest percentage terms of all the other combinations. The chart helps to show the relationship between the various portfolio combinations and risk. But remember, that risk is the result of the correlation between the actual assets included in the portfolio, and this chart represents a very simplistic analysis, based on the generic relationship between the asset classes.



How do I pick the model that is right for me?

It is important to realize that there is not a ‘one size fits all’ approach to asset allocation. Each investor is different and each investor has his or her own unique situation and goals. As you continue your research on asset allocation, you will find differing points of view for what approach to take. Nevertheless, in the end the question comes down to, “is this plan the right one for me based on my risk tolerance and investment objectives?” Whatever asset allocation you use, make sure that the plan addresses your goals and the risk you are willing to take in order to achieve your goals.

Remember, the more time you have to meet your investment objectives, the more you should weight your investment dollars toward stocks. Also, the more “risk adverse” you are, the less weighting you should apply to stocks—you cannot have your cake and eat it too when it comes to investing! Proper asset allocation is a careful balancing act between risk and expected return. Lastly, once you determine the proper asset allocation for your portfolio, reexamine it at least once per year to ensure the proportions stay aligned.